

A Northeast Asian Development Bank

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This paper discusses a Northeast Asian Development Bank in terms of three related propositions:

- (1) economic development and regional integration of Northeast Asia will require a huge capital investment in physical infrastructure during the next several decades;
- (2) existing financial sources, private, bilateral and multilateral, will not be able to provide the amounts and types of funds required for such infrastructure investment; and, therefore,
- (3) a new regional development bank will be needed if the region's capital investment requirements are to be met.

INFRASTRUCTURE NEEDS AND RELATED FINANCING REQUIREMENTS

A key barrier to the Northeast Asian region's economic development and integration is the inadequate state of its infrastructure. Transportation and communications facilities and services are far below what is needed to support viable regional economic development. Existing airports, harbors, ports, railroads, highways and pipelines, for example, date largely from the pre-World War II and the Cold War era. These obsolete systems dictate the basic directions and modalities of transportation in Northeast Asia. Inadequate electric power generation and distribution is a further debilitating infrastructure deficiency. Further down the development road, environmental protection and rehabilitation, transportation, communications, water and sewer facilities, and power distribution for new and renewed urban centers will also require major investments.

Given the early stage of discussions about the region's future economic development, it is not surprising that estimates of the capital investment required to bring Northeast Asia's infrastructure to a level adequate to sustain economic activity vary widely. While the amounts are uncertain, requirements will by any definition be very large. And besides the sizable amounts involved, the region will require financing for infrastructure with appropriate terms and conditions: that means long maturities (20-40 years),

extended grace periods (10-12 years), low interest charges and insurance against undue appreciation of repayment currencies.

Differences in the estimated amount of financing required arise from different assumptions about the development time horizon, the projects and programs to be included, the sectors and areas to be assigned priority and the level of economic development to be achieved. One recent model estimated that raising the capital:labor ratio of the region by the year 2005 to the level achieved by South Korea in 1983 would require a gross investment of some \$47 billion a year for the next decade. Net of the region's internal savings, the estimated requirement for external capital would be \$22-\$28 billion a year. Other estimates place annual net external requirements at \$36-\$42 billion. These amounts are generally in line with the estimated costs of developing the more limited Tumen River Economic Development Area (TREDA). A team of UNDP Experts Group that surveyed the Tumen River Economic Development Area in 1991 estimated that development of the area alone would require some \$30 billion of infrastructure investment over a twenty year period.

EXISTING SOURCES OF LONG-TERM INFRASTRUCTURE FINANCING

By any reasonable estimate, the amount of external capital needed to finance the region's future infrastructure requirements will be very large indeed. Not surprisingly, therefore, a question that sooner or later arises in most discussions of Northeast Asia's future economic development is that of financing—i.e., whether the substantial amounts of external capital that would be required could be raised; and, if so, how, when and by whom. The conventional financing sources have been identified; they include: (1) private investment, (2) bilateral official assistance, and (3) the multilateral international financial institutions. For reasons outlined below, these conventional sources will not be able to meet the region's needs.

Some portion of the new capital required to develop the region's infrastructure would no doubt come in the form of private direct investments. As in other developing countries and regions, the telecommunications and transportation sectors could attract private investors. Private sector financing arrangements for these kinds of facilities, including exporter credits, Build-Operate-Transfer (BOT) and Build-Own-Operate (BOO) schemes, have been used elsewhere in Asia and could be adapted to meet the region's requirements. Other infrastructure needs would probably not be of interest to private investors since such investments would likely be seen as carrying commercial, exchange and

political risks that are higher, and rates of return that are lower, than investments in other emerging-country markets. In this connection, the *London Economist* recently noted that the amount of private capital provided for infrastructure in emerging markets has been disappointingly modest and that "the vast majority of (infrastructure) deals still require a mix of government support, loans from development banks...and state-financed risk insurance...." On balance, therefore, it is not likely that more than a modest part of the region's new infrastructure investment needs could be financed by private investors.

A further part of Northeast Asia's projected infrastructure investment requirements would likely be met from existing governmental and non-governmental bilateral sources. The outlook for significant amounts of new funding for the region from these sources is not very encouraging. The main providers of bilateral development assistance in past years have been Japan, the United States and Western Europe. The Japanese economy is, however, substantially weaker today than it was when Japanese external assistance flowed relatively freely. Although Japan has maintained its assistance activities, it is not expected to soon again be in a position to allocate substantial amounts of domestic savings for bilateral development activities.

The U.S. economy is relatively stronger, but the past decade has seen the United States become more inward-looking. Public and private attention is now focused mainly on domestic matters—balancing the budget; downsizing government; and the upcoming elections. This inward-looking focus is accompanied by "aid-fatigue" which has all but erased public support for U.S. bilateral and multilateral development assistance. It must therefore be concluded that Northeast Asian infrastructure would find little support from U.S. bilateral financial sources.

Western Europe's support for Asian development has always been lukewarm; its assistance efforts are directed instead mainly to Africa and, to a lesser extent, to Central America. Europe's main external economic concerns are at present consolidating and strengthening the European Union and ensuring the economic and political opening and integration of Central and Eastern Europe.

In light of these circumstances, it must be concluded that substantial financing for Northeast Asia's infrastructure development from traditional bilateral sources would be unlikely.

A further source of prospective financial support for Northeast Asia's infrastructure development would, of course, be the existing multilateral development banks. These institutions have played an important supporting role in the development of many nations. However, the amounts of

assistance that might be forthcoming from these institutions for Northeast Asia would likely be far short of the region's requirements.

The World Bank (IBRD), the Asian Development Bank (ADB) and the European Bank (EBRD) each have loan programs in some, but not all, of the countries and regions that constitute the Northeast Asia development region. None of these three Banks presently includes North Korea among its members. Russia is a member of the World Bank and the European Bank but not of the ADB. China is a member of the World Bank and the ADB but not of the EBRD. Mongolia is a member of the World Bank and ADB but not of the EBRD. Japan and South Korea are, of course, members of all three institutions.

These three institutions have in fact provided substantial amounts of financial assistance for programs and projects in both Russia and China. With few exceptions, however, such financing has been directed to projects and programs in areas of those countries other than Northeast Asia that presumably enjoyed more visibility and higher priority with the central governments. It is reasonable to expect the World Bank, ADB and EBRD to extend some additional loans to these countries, some part of which might help finance the infrastructure needs of the region. However, pre-existing "claims" for projects in these countries, the limited amount of financing available from the development Banks, and the magnitude of Northeast Asia's projected long-term funding requirements, would undoubtedly mean that financing for Northeast Asia infrastructure from the existing development Banks would be much less than the region's requirements. The limitations on existing multilateral bank lending noted below unfortunately confirm this conclusion.

- **Capital Resources.** The World Bank, the ADB and the EBRD are each limited in the amount of loans and guarantees they can extend by their respective unimpaired capital and surpluses which set a ceiling on the amounts each can raise in external capital markets. Some of these institutions are or will soon be "loaned up" and must seek increases in shareholders' capital in order to support continued lending to their present client countries. Such increases in capital are becoming increasingly difficult to achieve. For that reason, their ability, individually and collectively, to undertake a substantial volume of new borrowing in capital markets in order to provide a large volume of new long-term loans for infrastructure in Northeast Asia would be limited.
- **Pre-Existing Commitments.** Each of the existing Banks has had long debtor-creditor relationships with its borrowing countries in terms, e.g., of part and indicative future levels of loans, guarantee and technical

assistance. It is doubtful that these Banks would be able to change the ground rules of these relations unilaterally to make room for large new lending to Northeast Asia. It is equally unlikely that current recipients of these Banks' loans would be willing to forego some of their future financial assistance in order to make room for new Northeast Asian borrowers.

- **Borrower Country Exposure.** From the multilateral Banks' viewpoint, it is essential to maintain their respective AAA credit ratings in capital markets. To do so, they must maintain a reasonable balance in their portfolio loan exposure among their major borrowing countries. In this regard, China and Russia are already two of the World Bank's largest borrowers; China is one of the ADB's largest borrowers; and Russia has a large volume of loan commitments from the EBRD. In view of these large country exposures, it is unlikely that the IBRD, ADB and EBRD would be in a position to provide either China or Russia significant amounts of new financing for infrastructure projects in their Northeast Asian provinces.
- **Country-specific Orientation.** The existing international development Banks were established to finance projects and programs principally within specific borrowing countries, and they have developed their programs and policies accordingly. A country-specific focus eliminates a number of complexities that are inherent in regional projects including, for example, determining the specific entity that is the legal borrower and is responsible for meeting the conditions stipulated in loan documents, for submitting required reports, for meeting deadlines, for funding shortfalls and for successful completion of the projects. For these reasons, regional projects are the exception rather than the rule in the portfolios of these institutions. For Northeast Asia, however, major benefits would accrue from regionally designed and executed projects.
- **Different Shareholder-Members.** Each of the multilateral Banks has its own unique group of member countries that have contributed to the institution's capital, staff and management and, as appropriate, are its beneficiaries. Since the Banks are precluded from extending assistance to non-member countries, none would be able to participate in financing regional projects that included North Korea among its beneficiaries. Regional projects that might otherwise be financed on a consortium basis would have to be divided, if possible, along country lines to ensure that only eligible countries received funding from the appropriate Bank(s). The EBRD, for example, could finance only the Russian

component of a regional project; the ADB, on the other hand, could not finance any of the Russian component. That requirement would raise obvious difficulties in regional projects for which costs and benefits could not be readily assigned in advance.

- **Staff and Administrative Constraints.** Each of the development Banks is currently operating with limited staffing and tight budgets for personnel, travel, consultants and other associated costs. Present staff have been assigned to specific countries or country-defined sectors, projects and programs. The imposition of a new set of regional demands on limited and already-stretched staff and budgets would further strain these institutions' resources and would likely encounter resistance.
- **Differences in Policies and Working Methods.** Each of the existing development Banks was organized to meet a specified set of objectives and needs, and each has accordingly developed its own distinctive "institutional culture" and has "grown" its own sets of policies and procedures. The EBRD, for example, is focused primarily on private sector development and 60% of its loan portfolio must be for private sector projects. EBRD financing for long-term infrastructure needs in Northeast Asia would therefore be doubtful. The ADB has developed a working approach that caters increasingly to its numerous small Pacific island-nation borrowers. This approach would not be suitable for Northeast Asian conditions. The World Bank is seen as being highly structured and prefers to link its financing to policy reforms by borrowing countries.

Each Bank has also developed its own operating methodology: loan criteria, documentation requirements, review and approval procedures, lending terms and conditions, and ex-post project assessment techniques. Each also sets its lending rates and repayment terms and conditions on the basis of on its own borrowing costs. Since such costs differ from Bank to Bank, a country that receives a co-financed loan from, e.g., the World Bank and the ADB would have to deal with different interest rates, repayment maturities and grace periods, and documentation and reporting requirements.

These institutional considerations—limited capital resources, pre-existing commitments, borrower country exposure, country rather than regional orientation, disparate membership, staff and administrative constraints, and differences in policies and methods—are the basis for the conclusion that only a relatively modest part of Northeast Asia's future

capital financing requirements could be met by the existing multilateral development Banks.

A NORTHEAST ASIAN DEVELOPMENT BANK: ROLE AND STRUCTURE

Based on this assessment, the conclusion that a new development institution is needed to take a major role in financing Northeast Asian infrastructure is all but inescapable. The need for such a "Northeast Asian Development Bank" arises from the facts adduced above, namely that: (1) the region's infrastructure is grossly deficient in terms of what is required to support future economic development; (2) upgrading and expanding the region's infrastructure base to adequate standards will require large amounts of external long-term financing; (3) existing private, bilateral and multilateral institutions cannot be counted on to take the lead in intermediating long-term financial resources from foreign capital markets to the Northeast Asia region, nor in meeting more than a modest share of the region's external financing needs; and (4) a new regionally-focused financial institution could help to mobilize the large volume of external resources required to develop the region's infrastructure. Thus, the answer to the questions: "Where will the money come from?" is, with a regional institution to serve as a financial intermediary, "From the capital markets of industrialized nations."

The idea of a new development Bank for Northeast Asia is not new. It was first proposed some five years ago by the former Prime Minister of the Republic of Korea, Nam Duck Woo, at a conference in Tianjin, China. The concept of a new regional Bank has since been discussed and considered at the annual meetings of the Northeast Asia Economic Forum and other international and regional organizations, and it has gained increasing support within the Asian academic, government and business communities. In this connection, it has been suggested that rather than a new Bank for Northeast Asia, concerned governments might establish a special Northeast Asia fund in the IBRD or the ADB. While that might be a helpful interim measure, contributed funds would have to be replenished every few years, an effort that is always difficult and often unrewarding. Moreover, a fund in an existing institution would not overcome the institutional programs outlined above. Most importantly, a special fund could not serve the essential function of capital intermediation since it would have no callable capital or other assets to pledge as collateral against its borrowings in foreign capital markets.

The main work of the proposed Bank would be the traditional one performed by each of the existing development Banks—to obtain funds at the best terms and conditions available in foreign capital markets, primarily by issuing its own securities in these markets, and applying the proceeds from such borrowing to financing infrastructure in the Northeast Asia region. A distinctive feature of the new Bank would be the fundamental regional, rather than national, orientation of the benefits to accrue from the projects and programs it would support. This approach would recognize the widely-endorsed view that maximum efficiencies in the transportation, communications, energy and environmental sectors can be achieved by planning and undertaking such activities on a region-wide basis.

The reach of the Bank's activities would extend only to Northeast Asia, and the Bank would thus be more sharply focused than the other development Banks. The new Bank would be expected to extend direct loans and guarantees and to maximize the use of alternative and supplementary financial sources by co-financing and/or syndicating its loans with private investors, the IBRD, ADB and EBRD. The proposed Bank would be essentially project oriented. While it might be concerned with policy issues relating directly to the projects it supported (e.g., tariffs and rate structures for electricity or shipping), the Bank would not become involved in macroeconomic policy issues.

In light of the rudimentary state of many areas of the Northeast Asian regional economy, it has been suggested that a new regional Bank could also help fill some of the region's other financing and institutional gaps. Such activities might include: (1) assisting in restructuring Russian and Chinese state-owned industries; (2) financing exports of goods and services and promoting tourism; (3) strengthening the region's institutions—including legal, organizational and financial systems and commercial practices; (4) expanding education and training facilities; (5) improving statistics and information flows; and (6) assisting the design and implementation of environmental projects.

The proposed Northeast Asia Development Bank would be primarily Asian in its culture, ownership and staffing and in the location of its headquarters. China, Japan, Russia, South Korea and Taiwan would presumably be the largest individual shareholders from within the Asian region. Other nations, including Mongolia and North Korea of Northeast Asia, as well as most current ADB regional members, including Australia, New Zealand and Hong Kong, would also be expected to become shareholders. Membership and significant (but not majority) shareholding by industrialized non-Asian nations would be necessary to ensure the marketability of the Bank's bonds in foreign capital markets. The United

States, Canada and the European Union nations would all be expected to become shareholders in the Northeast Asian Development Bank.

This ownership structure would give Asian nations the lead in developing the Bank's policies and programs. More importantly, Asian majority shareholding would overcome the funding and consequent program constraints imposed on existing institutions by Western majority shareholders whose aid fatigue, internal priorities and declining foreign exchange reserves make their additional support for the existing Banks problematic for the foreseeable future.

In view of its limited geographic reach and its proximity to the region's major shareholders and beneficiaries, the Bank should not be required to maintain a resident board of directors. Rather, the board of directors should be relatively small, should convene quarterly and should draw its members from the senior ranks of shareholder governments.

It has been suggested that the initial subscription of the new Bank's capital (calculated at 0.5% of regional members' GDP) would be in the range of US\$15-20 billion. The comparable amount for the ADB was US\$23 billion and for the African Development Bank, it was US\$21 billion. One half of the subscription would be paid-in by shareholders within 5 years, in part or in whole in convertible currencies. The balance would remain subscribed but "uncalled" and would be available (as in the other multilateral Banks) to serve as collateral for the Bank's bond issues in foreign capital markets. It is projected that this capital structure could support an initial annual level of Bank loans and guarantees for the region of some US\$2 or 3 billion. While these amounts appear modest in overall terms, they would be additional to co-financed and direct loans from other private, bilateral and multilateral sources and would meet an important part of the region's initial absorptive capacity for external infrastructure project financing.

SUMMARY AND CONCLUSIONS

This paper has addressed the need for a new regional development bank to help finance the infrastructure requirements of Northeast Asia. In terms of development potential, the region's vast natural resource, labor and capital complementarities, which define the region as a "Natural Economic Territory," provide a strong rationale for regionally based development. A major barrier to realizing the benefits of these complementarities and to accelerating the region's economic development and integration is the inadequacy of the region's physical infrastructure, notably in the areas of transportation, communications, energy and environmental protection.

The amounts and types of external long-term financing that would be required to bring the region's capital facilities to levels sufficient to support viable economic activity are large by any estimation. A review of existing private, bilateral and multilateral sources of long-term development financing that could be tapped to fund the region's infrastructure indicates that the region's requirements far exceed the resources that could be expected from these sources. The conclusion, therefore, is that a new, relatively small and sharply-focused regional development financial institution, a Northeast Asian Development Bank, is needed to carry the major burden of intermediation between foreign capital markets and Northeast Asia. The proposed Bank, working in close coordination with existing private investors and bilateral and multilateral organizations, is considered necessary to raise the region's infrastructure to a level that will support self-sustaining economic development in the Northeast Asian region.